United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

Signed

75-4257

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

ESTATE OF HERMAN KLEIN, Deceased, BEBE KLEIN, MALCOLM B. KLEIN and IRA K. KLEIN, Executors, and BEBE KLEIN, Individually,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF THE ISSUES PRESENTED

1. Whether the Tax Court correctly decided that taxpayer was not entitled to relief as an "innocent spouse" under Section 6013(e) since, reading the other spouse's partnership return as an adjunct to the joint return, there was not an omission from gross income of 25 percent of the "amount of gross income stated in the return" as required by Section 6013(e)(1)(A).

2. Whether the Tax Court properly held that the gross receipts test in Section 6013(e) is constitutional.

STATEMENT OF THE CASE

This case involves a federal income tax deficiency for the year 1955 in the amount of $27,524.80.[1] (R. 28.)[2] The case was assigned to and heard by Commissioner Charles R. Johnston pursuant to Rules 180 and 182 of the Tax Court Rules of Practice and Procedure. Commissioner Johnston filed his report, including his findings of fact and opinion, on October 15, 1974. He held that taxpayer[3] Bebe Klein did not qualify for relief as an "innocent spouse" under Section 6013(a) since the amount of gross income omitted from taxpayers' joint return did not exceed 25 percent of the amount of gross income stated therein. In an opinion filed on March 11, 1975, the Tax Court (Judge Dawson) adopted the report of Commissioner Johnston with minor modifications. The opinion is also reported at 63 T.C. 585 (1975). (R. 8-27.) The decision of the Tax Court was entered on October 6, 1975. (R. 28-30.) Taxpayers filed timely notice of appeal on November 18, 1975. (R. 7.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

1/ The parties entered into a stipulated decision as to the other deficiencies and additions to tax due from taxpayers for the years 1955 through 1960. (R. 28-30, 55-60.)

2/ "R." references are to the separately bound record appendix.

3/ Herman and Bebe Klein will be referred to from time to time as "taxpayers" because they filed joint returns. Bebe Klein in her individual capacity as a spouse seeking relief under Section 6013(e) is referred to as "taxpayer."

The relevant facts, as stipulated (R. 31-34), and as found by the Tax Court (R. 11-14), may be summarized as follows:

Herman Klein died August 30, 1964. The Surrogates Court of New York County, New York, on October 19, 1964, granted letters testamentary on the Estate of Herman Klein to Bebe Klein, Malcolm B. Klein and Ira K. Klein who duly qualified and were acting as executors at the time of the submission of the Tax Court proceeding. (R. 11-12.)

Herman Klein, during the year 1955, was engaged in the manufacture of dresses as a 30-percent partner in the partnerships of Miss Smart Frocks and C & S Dress Company, and as a stockholder in Miss Smart Frocks, Inc. A partnership return, Form 1065, for the taxable year beginning May 1, 1954, and ending April 29, 1955, of Miss Smart Frocks and C & S Dress Company, using the accrual method of accounting, was filed with the District Director of the Upper Manhattan District, New York, New York. For the year ending April 29, 1955, the partnership return of Miss Smart Frocks showed sales in the amount of $3,545,911.95 (R. 47) and a schedule for the C & S Dress Company included in the partnership return showed gross income from contracting in the amount of $141,457.40. (R. 34, 47, 50.) Schedule K of this partnership return also showed Herman Klein's 30-percent distributive share of the partnerships' ordinary net income to be $90,845.89. (R. 51.)

Herman Klein and Bebe Klein timely filed a joint return for the taxable year 1955 with the District Director of the Upper Manhattan District, New York. (R. 12, 35-43.) This joint return did not show the gross income included in the partnership return. (R. 12, 34.) It did, however, show the following items of income (R. 33, 41-42):

Schedule B. -Income From Interest	$ 191.21
Schedule G. -Income From Royalties	494.05
Schedule H. -Income From Partnerships	$90,845.89
Total	$91,531.15

The parties stipulated that taxpayers Herman Klein and Bebe Klein omitted the following items from gross income on their joint income tax return for the taxable year 1955 (R. 33):

Dividend Income	$21,994.29
Other Income	5,200.00
Partnership Income	18,495.74
Interest Income	43.25
	$45,733.28

The Commissioner determined a deficiency in the amount of $48,594.11 against taxpayers for the year 1955. (R. 55-60.) Taxpayer Bebe Klein contended that she was entitled to relief from liability for the deficiency under Section 6013(e) of the Internal Revenue Code.

The Tax Court (R. 9) concluded that taxpayer Bebe Klein was not entitled to relief from liability because she had failed to meet the requirement of Section 6013(e)(1)(A) that there be an omission from gross income attributable to the other spouse in excess of 25 percent of the "amount of gross income stated in the return."

In reaching its decision the Tax Court found the following items of gross income to be stated in taxpayers' joint return (R. 14):

Interest	$	191.21
Royalties		494.05
Distributive share of gross income of partnership, Miss Smart Frocks and C & S Dress Co.		$1,106,210.81
Total gross income reported		$1,106,896.07

The Tax Court also held (R. 27) that Section 6013(e) is constitutional. This appeal by taxpayers followed.

SUMMARY OF ARGUMENT

I

Herman and Bebe Klein elected the privilege of filing a joint return for 1955. Taxpayer Bebe Klein contends that she is entitled to relief from joint and several liability for the tax found due on the grounds that she is an "innocent spouse" under Section 6013(e). The parties stipulated that Bebe Klein meets two out of the three requirements under Section 6013(e). Thus, the issue on appeal is whether the Tax Court properly held that Bebe Klein did not meet the first requirement of the innocent spouse provision that there be an omission from gross income on the joint return attributable solely to Herman Klein in excess of 25 percent of the gross income stated in the return. The controversy centers on whether the phrase "amount of gross income stated in the return" found in Section 6013(e)(1)(A) includes Herman Klein's distributive share of the gross income of the Miss Smart Frocks and C & S Dress Company partnerships.

In determining whether there has been an omission from gross income in excess of 25 percent of the gross income stated in the return, the innocent spouse provision adopts the test in Section 6501(e)(1)(A) for invoking the 6-year rule for the assessment of taxes. This rule defines the term "gross income" for purposes of a trade or business as including the gross receipts of a business before diminution for expenses. Taxpayers concede that Bebe Klein is not an "innocent spouse" if this definition of "gross income" is applicable. Despite this concession, taxpayers seize upon the literal language of Section 6013(e) and contend that the gross receipts test in Section 6501(e)(1)(A) is to be consulted only with

reference to "the amount omitted from gross income" but not for the purpose of determining "the amount of gross income stated in the return."

Contrary to taxpayers' contentions, the legislative history makes it clear that Congress intended the innocent spouse provision to incorporate the rules of Section 6501(e)(1)(A) in their entirety in determining whether an omission exceeds 25 percent of the amount of gross income stated in the return. And even assuming arguendo, as taxpayers urge, that the definition in Section 6501(e)(1)(A) is to be ignored, the same result--namely the inclusion of Herman Klein's share of the gross receipts of the partnerships in the joint return-- is reached under Sections 61(a)(13) and 702(c). These two sections define the "gross income of a partner" as his "distributive share of the gross income of the partnership," and the legislative history under these two sections makes it clear that Congress intended this definition to be applicable in any case requiring the determination of a partner's gross income for income tax purposes. In the instant case, the Tax Court reviewed the applicable legislative history, Code sections, and previous decisions, and properly concluded that the partnership return of Miss Smart Frocks and C & S Dress Company must be considered together with Herman and Bebe Klein's joint return in determining the "amount of gross income stated in the return."

Taxpayers are also mistaken in their contention that the "amount of gross income stated in the return" is merely the total of the items of income actually "put down" by Herman and Bebe on their joint return for 1955. In effect, taxpayers are arguing that

Herman and Bebe Klein's gross income for purposes of their joint return includes only Herman Klein's distributive share of partnership net income. This argument, which was properly rejected by the Tax Court below, is simply contrary to the conduit rule governing the taxation of partnership income.

II

There is also no merit to taxpayers' arguments that the gross receipts test in Section 6013(e) is unconstitutional. The Supreme Court has held as a general rule that a legislative classification will not be set aside if any state of facts justifying it is perceived by the courts. In the instant case, the Tax Court correctly perceived a rational basis for the use of the gross receipts test in Section 6013(e) in the case of a trade or business. The Tax Court reasoned that since Congress limited relief to omissions from gross income, the use of the gross receipts test was proper. This rationale alone, we submit, provides a proper legislative classification for the statute challenged by taxpayers. And even if there were a constitutional basis for taxpayers' complaints, the appropriate remedy would not be to grant spouses a privilege not sanctioned by Congress, but rather to nullify the privilege altogether.

ARGUMENT

I

THE TAX COURT CORRECTLY DETERMINED, IN HOLDING THAT TAXPAYER WAS NOT ENTITLED TO RELIEF AS AN "INNOCENT SPOUSE" UNDER SECTION 6013(e), THAT THERE WAS NOT AN OMISSION FROM GROSS INCOME IN EXCESS OF 25 PERCENT OF THE "AMOUNT OF GROSS INCOME STATED IN THE RETURN"

A. The Tax Court correctly held that the partnership return of Miss Smart Frocks and C & S Dress Company must be read as an adjunct to Herman and Bebe Klein's joint return in determining the "amount of gross income stated in the return"

Herman Klein and Bebe Klein filed a joint federal income tax return for the taxable year 1955.[4/] Generally, individuals filing joint income tax returns are jointly and severally liable for any tax liability found to be due. See Section 6013(d)(3), Internal Revenue Code of 1954, Appendix, infra. Taxpayer Bebe Klein contends, however, that the relief provision of Section 6013(e) (commonly known as the innocent spouse provision) is applicable to absolve her of the tax liability found to be due for 1955. However, to be relieved from liability as an "innocent spouse," Bebe Klein has the burden of proving that she meets all three requirements of Section 6013(e). Appendix, infra. Altman v. Commissioner, 475 F. 2d 876 (C.A. 2, 1973); Sonnenborn v. Commissioner, 57 T.C. 373, 381 (1971). These requirements are: (1) there must be an omission from gross income attributable to the other spouse in excess of 25 percent of the

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4/ The filing of a joint return is entirely elective and has been described as a "highly valuable privilege to husband and wife since the resulting tax liability is generally substantially less * * *." Sonnenborn v. Commissioner, 57 T.C. 373, 380-381 (1971).

amount of gross income stated in the return; (2) the spouse seeking relief must not know, and have no reason to know, that there was a 25 percent omission when she signed the joint return; and (3) taking into account whether the spouse seeking relief significantly benefited (directly or indirectly) from the items omitted from gross income and taking into account all other facts and circumstances, it would be inequitable to hold the spouse liable for the tax on the omitted income.

The parties stipulated that Bebe Klein meets the second and third requirements. (R. 33.) Thus, the issue here is the propriety of the Tax Court's decision that Bebe Klein does not meet the first requirement of the innocent spouse provision. The controversy centers on the meaning of the phrase "amount of gross income stated in the return" found in Section 6013(e)(1)(A). Taxpayers contend (Br. 7-8) that this phrase refers only to the total of the items of income (here $91,531.15) actually "put down" by Herman and Bebe Klein on their joint return (R. 35-43) for 1955. The Tax Court held, however, that Herman Klein's distributive share of the gross income shown on the partnership return of Miss Smart Frocks and C & S Dress Company ($1,106,210.81) must be read as an adjunct with Herman and Bebe Klein's joint return for purposes of determining the "amount of gross income stated in the return." (R. 9, 19.) Since the $45,733.28 omitted from the joint return is not in excess of 25 percent of the $1,106,896.07 total gross income stated in the joint return, the Tax Court properly concluded that Bebe Klein does not qualify for relief as an "innocent spouse" under Section 6013(e). (R. 9.)

In determining whether there has been an omission from gross income in excess of 25 percent of the amount of gross income stated in the return, Section 6013(e)(2)(B) requires reference to Section 6501(e)(1)(A). Section 6501(e)(1)(A), Appendix, infra, contains a 25 percent gross income test which allows the Commissioner to assess a tax liability within 6 years after a return has been filed.

In linking the innocent spouse provision to the 25-percent gross income test for 6-year assessments, Section 6013(e)(2)(B) specifically provides that "the amount omitted from gross income shall be determined in the manner provided by section 6501(e)(1)(A)." Taxpayers in the instant case seize upon the literal language of Section 6013(e)(2)(B) and maintain (Br. 10-11) that Section 6501(e)(1)(A) is to be consulted only with reference to computing "the amount omitted from gross income" but not for the purpose of determining "the amount of gross income stated in the return." A similar argument was properly rejected by the Tax Court in Rodman v. Commissioner, P-H. Memo T.C., par. 73,277 (1973).[5/]

Contrary to taxpayers' contentions, the legislative history when read in conjunction with Section 6013(e)(2)(B) makes it clear that Congress intended the innocent spouse provision to incorporate the rules of Section 6501(e)(1)(A) in their entirety in determining whether an omission exceeds 25 percent of the gross income stated in the return. As the Senate Finance Committee

5/ Rodman is currently on appeal to this Court, No. 75-4251.

noted in explaining the reasons behind the enactment of the 25-percent gross income test under Section 6013(e) (S. Rep. No. 91-1537, 91st Cong., 2d Sess., p. 3 (1971-1 Cum. Bull. 606, 607)):

> The first requirement, that the amount omitted from gross income must equal more than 25 percent of the gross income shown on the return, is intended to limit the relief provided in the bill to those cases where the income omitted represents a significant amount relative to the reported income. Whether or not an omission meets this test is to be determined in a manner similar to the test applied under existing law in determining, for purposes of the 6-year statute of limitations [Section 6501(e)(1)(A)], when an omission in excess of 25 percent of gross income exists.

The Tax Court in the instant case reviewed this legislative history and properly concluded that (R. 18-19):

> As we read the first sentence we think "the income reported" by a partner includes his share of the gross income, as defined in section 6501(e)(1)(A)(i), of the partnership. Rev. Rul. 55-415, 1955-1 C.B. 412 and I.T. 3981, 1949-2 C.B. 78.

The definition of "gross income" in Section 6501(e)(1)(A)(i) referred to by the Tax Court covers situations where the return in question shows income from a trade or business, as in the case of the joint return filed by Herman and Bebe Klein. Subsection 6501(e)(1)(A)(i) defines the term "gross income" as including the gross receipts of a business before diminution for expenses. Subsection 6501(e)(1)(A)(i) specifically provides:

> In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods and services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services;

Taxpayers concede (Br. 10) that if this definition of gross income is used, the 25-percent gross income test is not met by taxpayer Bebe Klein because gross income under Section 6501(e)(1)(A) includes Herman Klein's $1,106,210.81 distributive share of the gross income shown on the partnership return of Miss Smart Frocks and C & S Dress Company. (R. 34, 47,50.) See § 301.6501(e)-1(a)(1)(ii), Treasury Regulations on Procedure and Administration (1954 Code), Appendix, infra.

Despite this concession, taxpayers urge this Court to ignore the definition of "gross income" in Section 6501(e)(1)(A)(i) because it is their erroneous view (Br. 10, 11) that Section 6501(e)(1)(A) is to be consulted only for purposes of computing amounts omitted from gross income. As we have shown above, the legislative history of the innocent spouse provision indicates otherwise. And even assuming arguendo, as taxpayers urge, that the definition of "gross income" in Section 6501(e)(1)(A)(i) is to be ignored, the same result--namely the inclusion of a partner's share of the gross receipts of the partnership in the partner's individual return--is reached under Sections 61(a)(13) and 702(c).

Section 61(a), Appendix, infra, defines the term "gross income" as "all income from whatever source derived * * *." And under Subsection 61(a)(13), the "[d]istributive share of partnership gross income" is specifically included as an item of "gross income." This definition is repeated in Section 702(c), Appendix,

infra, in broad language generally applicable to other provisions of the Internal Revenue Code:

> (c) Gross Income of a Partner.--In any case where it is necessary to determine the gross income of a partner for purposes of this title [Internal Revenue], such amount shall include his distributive share of the gross income of the partnership. (Emphasis added.)

The Senate Committee Report to the 1954 Code emphasized that this definition of "gross income" in Section 702(c) is applicable whenever the determination of a partner's gross income is required for income tax purposes (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 378 (3 U.S.C. Cong. & Adm. News (1954) 4621, 5019)):

> Subsection (c) [Subsection 702(c)] relates to the determination of a partner's share of the gross income of a partnership. It will be noted that section 61(a), which defines gross income, has been amended by your committee to make clear that a partner's gross income includes his distributive share of partnership gross income. However, under subsection (c), the determination of a partner's share of the gross income of the partnership need not be made annually, but only where the determination of the partner's individual gross income is required for income tax purposes. For example, a partner is required to include his distributive share of partnership gross income in computing his individual gross income for the purpose of determining the necessity of filing a return. A partner's gross income may also be relevant for other tax purposes, such as the application of the provision permitting the spreading of income for services rendered over a 3-year period (section 1301), the amount of gross income received from possessions of the United States, and the extended period of limitations applicable to deficiencies where there has been an omission of 25 percent of gross income. (Emphasis added.) 6/

6/ Senate Report No. 1622, supra, and Senate Report No. 91-1537, supra, both use similar language when referring to the 6-year statute of limitations provision in Section 6501. Specifically,

Thus, wholly apart from the definition of "gross income" in Section 6501(e)(1)(A), there can be no question that if a Code section requires a computation of the gross income of a partner --as does the innocent spouse provision under Section 6013(e)(1)(A) in the case at bar--Sections 61(a)(13) and 702(c) are applicable to define the "gross income" of a partner as including his

6/ (continued)

Senate Report No. 1622 states that a partner's gross income may also be relevant in cases "where there has been an omission of 25-percent of gross income," and Senate Report No. 91-1537, supra, states that the 25 percent gross income test in the innocent spouse provision is to be determined in a manner similar to the test for determining "when an omission of 25 percent of gross income exists." Thus, contrary to taxpayers' contentions, it is apparent that Congress was simply using the phrase "omission of 25 percent of gross income" as a short-hand term to refer in toto to the test for invoking the 6-year rule for the assessment of taxes. Indeed, Senate Report No. 1622, supra, p. 5233, uses the phrase "omission of 25 percent of gross income" as a byname for referring to Section 6501(e) in discussing the 1954 legislative changes to that very section:

> Several changes from existing law have been made in subsection (e) of this section. [Subsection 6501(e)]. In paragraph (1), which relates to income tax, the existing 5-year rule in the case of an omission of 25 percent of gross income has been extended to 6 years. The term "gross income" as used in this paragraph has been redefined to mean the total of the amounts received or accrued from the sale of goods or services prior to diminution by the cost of such sales or services. A further change from existing law is the provision which states that any amount as to which adequate information is given on the return will not be taken into account in determining whether there has been an omission of 25 percent. (Emphasis added.)

Thus, taxpayers' contention (Br. 14) that Section 6013(e)(2)(B) would have been worded more precisely if it had been intended that Section 6501(e)(1)(A) be consulted to determine the "amount of gross income stated in the return" is simply contrary to legislative history regarding the use of the phrase "omission of 25 percent of gross income."

distributive share of partnership gross income. The Tax Court in the instant case properly recognized this principle in holding that (R. 18):

> * * * the only way "the amount of gross income stated in the return" can be determined, where a partner of a partnership which has filed a return is concerned, is to consider the partnership return together with the individual return in determining "the total gross income stated in the return" of the individual partner. Genevieve B. Walker, 46 T.C. 630 (1966). See Nadine I. Davenport, 48 T.C. 921, 928 (1967); Accord, Elliot J. Roschuni, 44 T.C. 80 (1965), and Jack Rose, 24 T.C. 755 (1955). Cf. Section 702(c); Section 1.702-1(c)(2), Income Tax Regs.

We submit that this holding is in line with the plain language of Sections 702(c), 6013(e), and 6501(e)(1)(A), the provisions of the applicable Treasury Regulations, and the comments in the Committee Reports.

B. There is no legal basis for taxpayers' argument that the "amount of gross income stated in the return" is $91,531.15

Taxpayers' contend (Br. 7, 8) that the "amount of gross income stated in the return" for purposes of the 25-percent gross income test in Section 6013(e)(1)(A) is merely the total of the items of income actually "put down" by Herman and Bebe Klein on their joint return for 1955--here $91,531.15. In effect, taxpayers are arguing that Herman and Bebe Klein's gross income for purposes of their joint return includes only Herman Klein's distributive share of partnership net income--here $90,845.89--(plus $685.26 of other interest and royalty income not at issue). This argument, which was properly rejected by the Tax Court, is

simply contrary to the general principles governing the taxation of partnership income.

Generally, under the Internal Revenue Code of 1954, a partnership is not considered a taxable entity in itself, but rather is regarded as a conduit of income and expense to each of the partners.[7/] See Section 701, Appendix, infra. Each partner, in computing his liability for tax in his individual capacity, must take into account separately his distributive share of certain items of income, gain, loss, deduction, or credit. Section 702(a), Appendix, infra. Under the "conduit" rule in Section 702(b), each item of income realized by the partnership retains its original identity and is treated on the partner's individual income tax return as if such item were realized directly by the partner from the source from which it was realized by the partnership. Section 702(b), Appendix, infra. Thus, a partner's distributive share of a partnership income item, such as ordinary net income, continues to be ordinary net income when taken into account on the partner's individual tax return.

7/ Thus, taxpayers are also mistaken in their argument (Br. 8) that the Commissioner would read the phrase "stated in the return" in Section 6013(e)(1)(A) as "stated in the returns." Taxpayers forget that a partnership is not a taxpayer but merely serves as an accounting unit for purposes of calculating the income and credits of the partners. Sections 701 and 702(a). Hence, the partnership return required to be filed by the Miss Smart Frocks and C & S Dress Company partnership under Section 6031 of the Code is merely an information return, as opposed to the income tax return filed by taxpayers under Section 6013(a). 6 Mertens, Law of Federal Income Taxation (Rev.), § 35.91, p. 265; Rose v. Commissioner, 24 T.C. 755, 768-769 (1955); Cf. Roschuni v. Commissioner, 44 T.C. 80, 84-86 (1965).

A case illustrating the pass-through of gross income from a partnership to the partner, while still retaining its character as gross income is Palda v. Commissioner, 253 F. 2d 302 (C.A. 8, 1958). That case involved a statute (Section 251(a) of the Internal Revenue Code of 1939) which exempted income from tax if 80 percent or more of an individual's gross income was derived from sources within a United States possession. The taxpayer in Palda had an interest in a construction partnership within a possession and argued, just like the taxpayers in the instant case argue, that only his distributive share of partnership net income should be taken into account in computing the qualifying percentage. The Court of Appeals disagreed, holding that the partner's "share of gross income of the business is necessarily his gross income." 253 F. 2d, p. 309. See also Rodman v. Commissioner, P-H. Memo T.C., par. 73,277 (1973), where the Tax Court, in holding that the taxpayers' wives were not entitled to relief as "innocent spouse[s]" for failure to pass the 25-percent gross income test, treated the partnership as a mere conduit stating (P-H. Memo T.C., par. 73,277, p. 1271):

> The characterization of "gross income" on the partnership level is determinative of "gross income" on the partner level since the partnership return must be read as an adjunct with an individual partner's return in determining total gross income stated in the individual's return.

In the instant case, Schedule K of the partnership return of Miss Smart Frocks and C & S Dress Company for the taxable year ending April 29, 1955, shows the partners' shares of ordinary net income as follows:

Schedule K (R. 51, 54)

Name of Partner	Ordinary Net Income
Herman Klein	$90,845.89
Max Roseman	87,920.88
Joseph Buffa	66,413.93
Leo Carlino	66,413.92
James Sabella	0
Total Ordinary Net Income	$311,594.62

Herman Klein's distributive share of the partnerships' "ordinary net income" was reported on taxpayers' joint return for 1955 as "Income From Partnerships--Miss Smart Frocks--$90,845.89." (R. 42.)

Contrary to taxpayers' contentions (Br. 7) that this amount becomes "gross income" when shown on the Form 1040, there can be no question that under the "conduit" rule in Section 702(b) Herman Klein's share of partnership "ordinary net income" continues to be "ordinary net income" when taken into account on the joint return.[8/] See Section 702(a) and Palda v. Commissioner, supra. In addition, the very face of taxpayers' joint return (R. 35) shows "ADJUSTED GROSS INCOME" in the amount $89,344.52. "Adjusted gross income" is defined in Section 62(1),

8/ Taxpayers appear to concede this point when they later argue (Br. 16) that the "gross receipts of the partnership were over a million dollars (Stipulation, Item 13), whereas the net income from the partnership was $109,341.63 (Stipulation, Items 7 and 8)."

Appendix, infra, as "gross income minus the following deductions," one of which is "trade or business" deductions. Thus, put into the context of the Miss Smart Frock and C & S Dress Company partnerships, Herman Klein's "gross income" refers to his distributive share of the partnerships' total income from sales and contracting work, which in this case the Tax Court correctly determined to be $1,106,210.81. (R. 14.) On the other hand, the "adjusted gross income" shown on the face of Herman and Bebe Klein's Form 1040 refers to the total gross income of the partnerships less deductions, and represents, in effect, Herman Klein's distributive share of partnership net income.

In sum, Herman Klein's $90,845.89 share of partnership "ordinary net income" when viewed under the applicable principles governing partnership taxation is not, by any stretch of the imagination, "gross income" as taxpayers here contend. Thus, the Tax Court was therefore surely correct in refusing to extend the benefits of the innocent spouse statute to taxpayer Bebe Klein since the omissions from gross income attributable to Herman Klein did not exceed 25 percent of the $1,106,896.07 gross income stated in their joint return.

Ignoring the foregoing, however, taxpayers (Br. 12-13) make a policy argument that it makes "good sense" to use a net income test in Section 6013(e) rather than a gross income test in the case of a trade or business because it makes it easier for a taxpayer whose husband is a partner in a business with small net income to qualify as an"innocent spouse." The position urged

here by taxpayers would discriminate against "innocent spouse[s]" of sole proprietors since Schedule C of Form 1040 requires sole proprietors to report the gross sales of their businesses directly on their joint income tax returns.[9/] Moreover, the same "net income" policy argument was rejected by the Supreme Court in Colony, Inc. v. Commissioner, 357 U.S. 28 (1958), a case involving the gross income test under Section 6501(e)(1)(A). There the Supreme Court noted that if Congress had intended such a broad construction of the statute, "one might have expected to find * * * [it] cast in terms of errors in the total tax due or in total taxable net income." 357 U.S., p. 36. Likewise, we think that it is clear from the legislative history and plain language of the innocent spouse provision that Congress intended to limit relief to those cases involving omissions from gross income, and not, as taxpayers urge, from net income.

9/ See Howse v. Commissioner, P-H. Memo T.C., par. 74,225 (1974), for a case illustrating the gross income test of Section 6013(e)(1)(A) applied to the "innocent spouse" of a sole proprietor. See also Schedule C (Profit or (Loss) From Business or Profession).

II

THE TAX COURT CORRECTLY HELD THAT THE GROSS RECEIPTS TEST IN SECTION 6013(e) IS CONSTITUTIONAL

Taxpayers also argue (Br. 14-15) that the gross receipts test in Section 6501(e)(1)(A) as adopted by Section 6013(e)(1)(A) to determine the "amount of gross income stated in the return" is unconstitutional. They complain (Br. 15-16) that the gross receipts test in Section 6013(e) is arbitrary and capricious because it causes an otherwise innocent spouse to be denied relief in the case where the guilty spouse is a partner in a partnership with substantial gross receipts but relatively little net income. As we shall demonstrate, however, the use of the gross receipts test in the innocent spouse provision, far from being an unconstitutionally discriminatory classification, was rather the product of carefully drafted legislation well within the power of Congress.

It has been settled for at least a half a century that Congress' power to classify for federal tax purposes is extremely broad and that such classifications do not per se violate the constitutional dictates of due process. Thus, the Supreme Court has held that a tax statute can violate the Fifth Amendment only (Brushaber v. Union Pac. R. R., 240 U.S. 1, 24-25 (1916)--

> where although there was a seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a * * * taking of the same in violation of the Fifth Amendment; or * * * was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.

More recently, in United States v. Maryland Savings-Share Ins. Corp., 400 U.S. 4 (1970), the Court stated (400 U.S., p. 6):

> Normally, a legislative classification will not be set aside if any state of facts rationally justifying it is demonstrated to or perceived by the courts.

In the instant case, the Tax Court, relying on Maryland Savings-Share Corp., supra, p. 6, did perceive a rational basis for the use of the gross receipts test under the innocent spouse provision in the case of a trade or business. The Tax Court explained (R. 23-24):

> Since Congress restricted its relief under section 6013(e) to cases involving omissions from gross income, the use of a gross receipts test in the case of a trade or business was proper.

This rationale alone, we submit, provides a proper legislative classification for the statute challenged by taxpayers. Moreover, the legislative history under Section 6013(e) indicates that Congress intended the gross income test "to limit the relief provided in the bill to those cases where the income omitted represents a significant amount relative to the reported income." S. Rep. No. 91-1537, supra, p. 3. Congress cannot be said to have acted unreasonably in using a gross receipts test in the case of a trade or business to accomplish this goal.

That Congress might have gone further and extended the innocent spouse relief provision by use of a "net income" test as taxpayers argue is irrelevant, since the Supreme Court has frequently held that legislative reform is not invalid merely because it does not go far enough. Williamson v. Lee Optical Co., 348 U.S. 483, 489 (1955). The Tax Court below correctly recognized this principle stating (R. 26-27):

> Congress has apparently decided the potential injustice was greatest where an omission from gross income occurred and joint returns were filed. In so limiting its remedy Congress was not bound to include others.

See also, Dandridge v. Williams, 397 U.S. 471, 485 (1970); Kellems v. Commissioner, 58 T.C. 556 (1972), aff'd per curiam, 474 F. 2d 1399 (C.A. 2, 1973), cert. denied, 414 U.S. 831 (1973).

Nor is the Tax Court's holding in the instant case undermined by Moritz v. Commissioner, 469 F. 2d 466 (C.A. 10, 1972), cert. denied, 412 U.S. 906 (1973), on which taxpayers place major reliance. Moritz involved a constitutional challenge to Section 214 of the Internal Revenue Code of 1954 which, prior to 1972, allowed a limited deduction for expenses incurred in the care of dependents to "a taxpayer who is a woman or widower, or * * * a husband whose wife is incapacitated or institutionalized," but did not allow such a deduction to a man who had never married. In extending the benefits of Section 214 to unmarried males, the Tenth Circuit reasoned that the statute "made a special discrimination premised on sex alone, which cannot stand." 469 F. 2d,

p. 470. Since the innocent spouse provisions do not discriminate on the basis of sex, the reasoning in Moritz--as this Court noted in Kellems v. Commissioner, 474 F. 2d, p. 1399--is "inapposite."[10/] Similarly, taxpayers' reliance on Heiner v. Donnan, 285 U.S. 312, 325 (1932), is also misplaced since that case involved the constitutionality of "a statute which imposes a tax upon an assumption of fact which the taxpayer is forbidden to controvert * * *."

Moreover, taxpayers' brief completely ignores any mention of the Seventh Circuit's recent decision in Quinn v. Commissioner, 524 F. 2d 617 (1975). There the Seventh Circuit, in holding the innocent spouse provision to be constitutional, stated (524 F. 2d, p. 627):

> The statute [Section 6013(e)] in no way draws suspect classifications or invidiously discriminates. It is not vague as applied to this case. We cannot hold that the conditions placed on the relief provision are unreasonable or in any way deny due process.

Accordingly, we submit that the Tax Court in the instant case was clearly correct in holding that the taxpayers "have failed to sustain their burden of overcoming the presumption of the validity of Section 6013(e)." (R. 27.)

Finally, we note that even assuming that there is a constitutional basis for taxpayers' complaint of discrimination, it does not necessarily follow that the proper remedy is to enlarge the

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10/ Reed v. Reed, 404 U.S. 71 (1971), relied on by taxpayers, is also distinguishable on the basis of sex discrimination. Reed involved a provision of Idaho probate law giving preference to men over women in qualifying for appointment as administrator of a decedent's estate.

scope of the innocent spouse provision as taxpayers urge. If a statute is defective because of underinclusion, a court may declare it a nullity and order that its benefits not extend to the class that the legislature intended to benefit. Davis v. Wallace, 257 U.S. 478, 484-485 (1922). Compare Welsh v. United States, 398 U.S. 333, 361-367 (1970) (concurring opinion of Mr. Justice Harlan). We have demonstrated that the legislative history and plain language of Section 6013(e) indicate that Congress intended to limit relief to those cases involving omissions from gross income. It follows that the only practicable remedy, if one is to be given, would be to declare the innocent spouse provision a nullity so as to not enlarge the legislative intention. Thus, if Section 6013(e) is unconstitutional, it is unenforceable in toto, and taxpayer Bebe Klein is left with her tax liability as provided by Section 6013(d). Section 6013(e) is either constitutional or unconstitutional as a whole and, either way, taxpayer Bebe Klein cannot escape her joint and several tax liability.

In sum, the system adopted by Congress in 1971 for the relief of "innocent spouses," is reasonable, and as such it satisfies the requirements of due process and equal protection.

CONCLUSION

The decision of the Tax Court should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 4th day of March, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

(13) Distributive share of partnership gross income;

* * *

SEC. 62. ADJUSTED GROSS INCOME DEFINED.

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions.--The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

* * *

SEC. 701. PARTNERS, NOT PARTNERSHIP, SUBJECT TO TAX.

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) General Rule.--In determining his income tax, each partner shall take into account separately his distributive share of the partnership's--

(1) gains and losses from sales or exchanges of capital assets held for not more than 6 months,

(2) gains and losses from sales or exchanges of capital assets held for more than 6 months,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170(c)),

(5) dividends with respect to which there is provided a credit under section 34, an exclusion under section 116, or a deduction under part VIII of subchapter B,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) partially tax-exempt interest on obligations of the United States or on obligations of instrumentalities of the United States as described in section 35 or section 242 (but, if the partnership elects to amortize the premiums on bonds as provided in section 171, the amount received on such obligations shall be reduced by the reduction provided under section 171(a)(3)),

(8) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

(b) Character of Items Constituting Distributive Share.--The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

(c) Gross Income of a Partner.--In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

SEC. 6013. JOINT RETURNS OF INCOME TAX BY HUSBAND AND WIFE.

* * *

(d) Definitions.--For purposes of this section--

* * *

(3) if a joint return is made, the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several.

(e) [as added by Sec. [1], Act of January 12, 1971, P.L. 91-679, 84 Stat. 2063] Spouse Relieved of Liability in Certain Cases.--

(1) In general.--Under regulations prescribed by the Secretary or his delegate, if--

(A) a joint return has been made under this section for a taxable year and on such return there was omitted from gross income an amount properly includable therein which is attributable to one spouse and which is in excess of 25 percent of the amount of gross income stated in the return,

(B) the other spouse establishes that in signing the return he or she did not know of, and had no reason to know of, such omission, and

(C) taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted from gross income and taking into account all other facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such omission,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent that such liability is attributable to such omission from gross income.

(2) Special rules.--For purposes of paragraph (1)--

(A) the determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to community property laws, and

(B) the amount omitted from gross income shall be determined in the manner provided by section 6501(e)(1)(A).

* * *

SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

* * *

(e) Omission From Gross Income.--Except as otherwise provided in subsection (c)--

(1) Income taxes.--In the case of any tax imposed by subtitle A--

(A) General rule.--If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this sub-paragraph--

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.702-1 Income and Credits of partner.

* * *

(c) Gross income of a partner. (1) Where it is necessary to determine the amount or character of the gross income of a partner, his gross income shall include the partner's distributive share of the gross income of the partnership, that is, the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in section 702(a)(1) through (8)). For example, a partner is required to include his distributive share of partnership gross income:

(i) In computing his gross income for the purpose of determining the necessity of filing a return (section 6012(a));

(ii) In determining the application of the provisions permitting the spreading of income for services rendered over a 36-month period (section 1301, as in effect for taxable years beginning before January 1, 1964);

(iii) In computing the amount of gross income received from sources within possessions of the United States (section 931); and

(iv) In determining a partner's "gross income from farming" (sections 175 and 6073).

(2) In determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a partner's gross income includes his distributive share of partnership gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of partnership gross income from which was derived the partner's distributive share of any item of partnership income, gain, loss, deduction, or credit (as included or disclosed in the partner's return) is considered as an amount of gross income stated in the partner's return for the purposes of section 6501(e). For example, A, who is entitled to one-fourth of the profits of the ABCD partnership, which has $10,000 gross income and $2,000 taxable income, reports only $300 as his distributive share of partnership profits. A should have shown $500 as his distributive share of profits, which amount was derived from $2,500 of partnership gross income. However, since A included only $300 on his return without explaining in the return the difference of $200, he is regarded as having stated in his return only $1,500 ($300/$500 of $2,500) as gross income from the partnership.

* * *

§ 1.6013-5. Spouse relieved of liability in certain cases.

(a) In general. A person shall be relieved from liability for any tax, penalties, additions to tax, interest, or other amounts, to the extent that such liability is attributable to an omission from gross income in a taxable year, and--

(1) He filed a joint return with a spouse in such taxable year,

(2) An amount of income which exceeds 25 percent of the amount of gross income which is stated in the return (as determined in a manner provided by section 6501(e)(1)(A) of the Code) and which is attributable to such person's spouse was omitted from the return, and should have been, under chapter 1 of the Code, included in the return,

* * *

Treasury Regulations on Procedure and Administration (1954 Code) (26 C.F.R.):

§ 301.6501(e)-1 Omission from return.

(a) Income taxes--(1) General rule. (i) If the taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A of the Code an amount properly includible therein which is in excess of 25 percent of the gross income so stated, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

(ii) For purposes of this subparagraph, the term "gross income", as it relates to a trade or business, means the total of the amounts received or accrued from the sale of goods or services, to the extent required to be shown on the return, without reduction for the cost of such sales or services. An item shall not be considered as omitted from gross income if information, sufficient to apprise the district director of the nature and amount of such item, is disclosed in the return or in any schedule or statement attached to the return.

* * *